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You Can't Rush a Recovery

While small business struggles, Goldman Sachs was protected from its AIG mistakes.

By AMAR BHIDÉ

The U.S. has already committed nearly $3 trillion to rescue the financial system and domestic auto makers, according to a recently released report by a special inspector general.

Treasury alone has announced plans to fork over more than $600 billion in TARP funds, and Treasury Secretary Timothy Geithner seems to announce a scheme a week to jump-start the economy. Unfortunately, just as vigorous thumping won't accelerate -- and can even disrupt -- the rebooting of a computer, unpredictable interventions and improvised initiatives jeopardize rather than hasten robust economic recoveries.

Sustainable recoveries cannot be rushed because individuals and firms can't instantly pick the best possible alternative. We can't immediately auction off our labor to the highest bidder, for instance. Rather we must devote time and effort to finding a suitable job. Once we find a position that satisfies us and learn to do it well, we are loath to leave.[*]

But miscalculations may end presumptively permanent arrangements: We may be laid off from a job we thought was safe because our employer built a new plant to satisfy demand that did not materialize. Then we not only have to search for a new job but also unwind old arrangements -- negotiating severance or selling our home if we have to move to a new city.

Similarly, our employer has to figure out how best to downsize or redeploy excess capacity. And in a recession, searching for new arrangements and the unwinding of old ones -- and anxiety that our turn may be next -- is widespread.

Our government plays an important ameliorative role. Unemployment benefits stop major dislocations from creating the widespread hunger and homelessness experienced in the Great Depression. They also prevent the anxiety of more than 90% of the workforce that remains

[*] See Herbert Simon's work on 'satisficing' search and Nelson and Winter's on 'routines'.

Note: Footnotes were not in the original and have been added by the author.

employed from turning into a panic.

Bankruptcy laws and courts facilitate the orderly unwinding of obligations that individuals and businesses can no longer meet or easily resolve through bilateral negotiations (as is often the case when a troubled business faces many creditors with different kinds of claims). A bankruptcy code that quickly salvages the greatest possible value from failure is crucial for our economic dynamism.

The Federal Deposit Insurance Corporation (FDIC) immediately assumes the liabilities of failed banks and then gradually disposes of their assets -- a process that has ended the bank runs that used to trigger depressions until the 1930s. But beyond amelioration and providing the judicial (or in the case of the FDIC, quasi-judicial) procedures for reorganization, there is little more that the government can do to accelerate the unwinding and renewal necessary to put the economy back on an even keel.

The process involves a sequence of negotiations and experiments that cannot be truncated by throwing in more resources. As Frederick Brooks wrote in his celebrated book on software development, "The Mythical Man-Month: Essays on Software Engineering": "When a task cannot be partitioned because of sequential constraints, the application of more effort has no effect on the schedule. The bearing of a child takes nine months, no matter how many women are assigned." "Brooks's Law" suggests that increasing the size of software teams may delay development.

The wide variety of problems and circumstances in an economic downturn precludes the effective use of a single solution.[*] And the federal government doesn't have the capacity to determine adjustments on a case-by-case basis. The late Nobel Laureate Friedrich Hayek taught that the "man on the spot" with the appropriate local knowledge was much more capable of making good investment decisions than a central planner.

Similarly, the men and women who are closest to the situation have a huge advantage in unwinding the consequences of past miscalculations. The terms of a problem loan are best renegotiated by the borrower and the bank that made the loan. How to cut costs and excess capacity in the automobile industry is best figured out by management, the UAW, bondholders and creditors, under Chapter 11 if necessary.

Ad hoc interventions in the financial markets by the executive branch and Federal Reserve that override private renegotiations and judicial procedures have done serious, long-term harm. Brokering the bailout of Long-Term Capital Management in 1998 by invoking the specter of systemic collapse encouraged banks to ignore the risks of trading with overextended counterparties and laid the groundwork for our current debacle.

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[*] When tulip bulb prices collapsed in the 17th century, the Dutch parliament reportedly required short-sellers to forgo 90 percent of their profits, thus saving those who had taken long positions from ruin. But the tulip bulb mania involved nearly identical transactions in single kind of commodity whereas today's misalignments are far more diverse. Decreeing a 10% cut in all wages or interest payments isn't a sensible way to reduce unemployment or stabilize credit markets.

The folly was compounded by the bailouts of Bear Stearns and AIG. The bailouts also undermined vital public confidence in the fairness of our system. While small businesses struggle to recoup bills owed by failed customers, the likes of Goldman Sachs, which miscalculated the creditworthiness of AIG, were made whole -- and could thus pay bonuses amounting to many times the incomes of most taxpayers.

Former Treasury Secretary Henry Paulson's Super-SIVs and TARPs eroded rather than helped restore confidence by promoting the belief that things must be really awful for the government to suspend due process and operate in secrecy. The schemes also delayed the actual cleaning up of the balance sheets of large banks. It did so by insulating them from FDIC discipline, and by creating the expectation that the next taxpayer-funded initiative would offer even more cash for their trash.

Mr. Geithner, who was closely involved with the AIG bailout, offers no change we can believe in. His latest scheme is called the Public-Private Partnership Investment Program. But there is actually very little private skin in this game: It gives a handful of wealthy financiers huge nonrecourse loans to enable them to purchase toxic assets that the market supposedly won't buy at a "fair" price. As the housing crisis has shown, providing subsidized nonrecourse loans creates asset bubbles, not true price discovery. And bribing buyers to ramp up prices smacks of market manipulation.

Suppose that, when the financial crisis broke two years ago, our leaders had shown a Churchillian steadfastness and allowed the normal realignment to play out under a predictable judicial and regulatory regime. The prices of stocks, bank debt and houses would still have crumbled and unemployment risen. Although recovery wouldn't have been immediate, we'd at least have progress, instead of a sullen paralysis and futile efforts to turn the clock back.

More loans would have been renegotiated and foreclosed properties auctioned off. The FDIC would already be engaged in finding a good home for the loans and deposits of a megabank or two. That agency, now operating with about one-third the staff it had in the 1980s, could also have used some of the bailout money that helped pay for bonuses at AIG and its counterparties to recruit, train and retain more employees.

Best of all, more entrepreneurs and innovators, who capitalize on the opportunities to be found in the midst of turmoil, could have been building the foundations of a prosperous future..

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